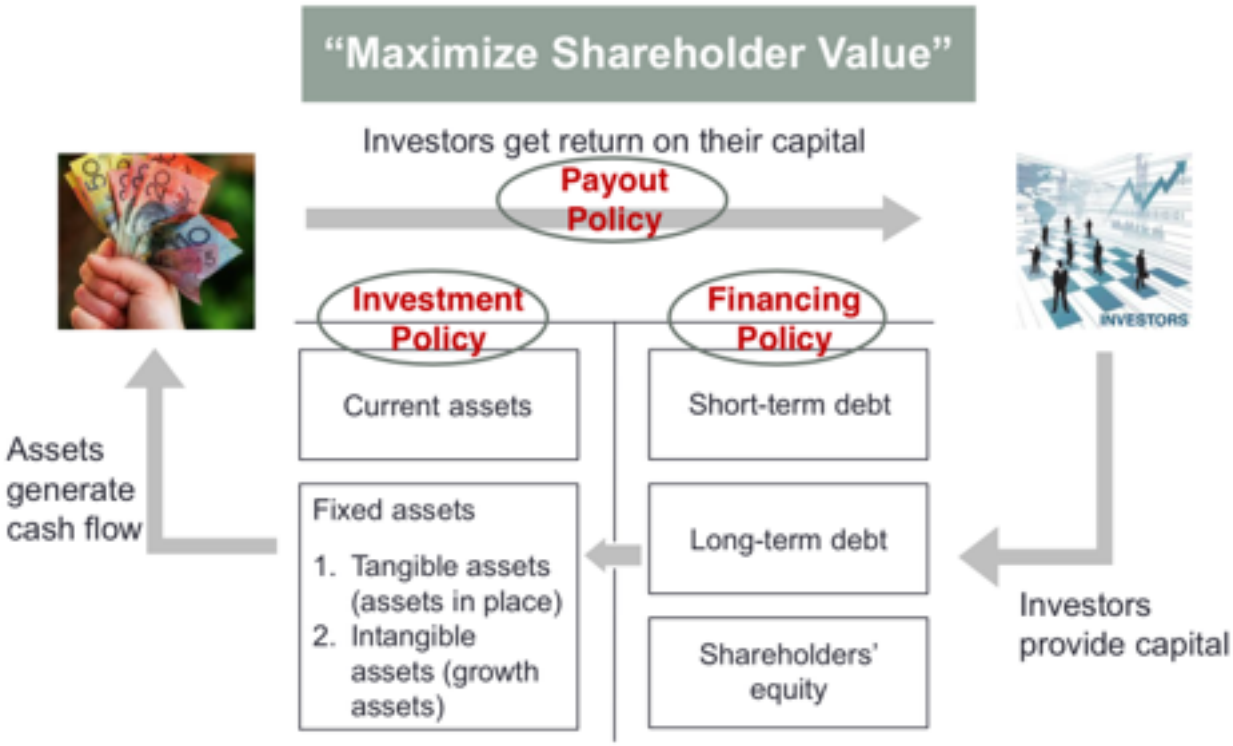
FNCE30002: Corporate Finance Notes

Lecture 1:



- Objective of Corporate Finance:
  - Maximise the long term value of the firm
  - Maximise shareholder wealth (or stock price if firms are public and markets are rational and reasonably efficient)
- Three key decisions:
  - Investment (spend)
  - Financing policy (raise)
  - Payout policy (return)
- Sources of funds (Financing policy)
  - Internal funds (retained earnings, cash)
  - Debt (borrowing)
  - Equity (issuing new shares)
  - Hybrids

Debt - Bank Debt - Commercial Paper - Corporate Bonds	**Hybrid Securities:** Convertible Debt Preferred Stock Option-linked Bonds	**Equity** Owner's Equity Venture Capital Common Stock, Warrants
Fixed Claim		Residual Claim
Tax Deductible		Not Tax Deductible
High Priority in Financial Trouble		Lowest Priority Financial Trouble
No Management Control		Infinite
		Management Control
Paid First		**Paid only from remaining cash flow (Higher expected RoR)**

- Pecking order perspective
  - Public firms tend to finance their projects first with retained earnings, then with debt and then equity (last resort)
  - Reason —> Information Asymmetry
    - Managers have more information about the firm than outsiders
    - Manager prefer to issue equity when equity is overvalued
    - Equity issues signal to investors that equity is overvalued
    - Stock price declines at equity issue announcement
    - Managers avoid issuing equity

Raising Equity Capital

Unlisted Firms	**Listed Frims**
- Private Equity Financing —> Angel Finance —> Venture capital - Initial Public Offering (IPO) —> Listing shares first time	- Private placement —> Small group of investors - Rights issue —> Existing shareholders - Dividend reinvestment plan —> To existing shareholders (offered to reinvest dived to apply for new shares)

- Private Equity (issuing shares not publicly traded)
  - 'Angel' Finance
    - Informal market for direct equity finance provided by a small number of high net worth individuals

Finance Lease Value - **Example**

- Davids Ltd need to use a machine for its project that costs $78,000 and has an expected life of 4 years and a residual (or salvage) value of $20,600
- Leased for four years with annual payments of $21,300 payable in advance
- Company tax rate - 34%
- Straight-line depreciation (full depreciation) is used
- The cost of borrowing is 15% p.a (before tax)
- Required rate of return from macing - 22% p.a (in order to purchase)

(1) **Identify incremental cash flows:** Lease payments (-) = -$21,300 (from year 0)

Tax shields from lease payment (+) = 0.34 x $21,300 - $7,242 (from year 0)

(2) **Identify cash flow from borrow to buy:** Cost of asset (+) = $78,000 (in year 0)

Tax-shields from asset depreciation (-) (from year 1) = 0.34 x ($78,000/4) = -$6,630

Residual asset value (-) = - $20,600 (year 4)

Book Value of Asset = Historical Cost - Accumulated depreciation

Gain/Loss on sale = (Residual Value - Book Value)

Tax on Gain or Loss = Tax Gain (loss) x t_c = ($20,600 - 0) x 0.34 = +$7,004

Incremental Cash Flow for each period = (1) - (2)

Description	July 2010	July 2011	July 2012	July 2013	July 2014
Cost	+$78,000				
Lease Payment	-21,300	-21,300	-21,300	-21,300	
Tax Shield	+7,242	+7,242	+7,242	+7,242	
Depreciation Tax Shield		-6,630	-6,630	-6,630	-6,630
Residual					-20,600
Tax on Gain/Loss					+7,004
Total	63,942	-20,688	-20,688	-20,688	-20,226

(2) After-tax cost of borrowing = 15% x (1 - 0.34) = 9.9% (discount rate captures tax-shields on inters payments when bottling money, the net cost of borrowing)

(3) NPV incremental cash flows:

So, Davids Ltd should reject the lease and borrow money to buy the machine

$$\begin{aligned} NPV &= 63{,}942 - \frac{20{,}688}{(1.099)} - \frac{20{,}688}{(1.099)^2} - \frac{20{,}688}{(1.099)^3} - \frac{20{,}226}{(1.099)^4} \\ &= 63{,}942 - 65{,}403.68 \\ &= -\$1{,}461.68 \end{aligned}$$